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FINANCIAL SECTOR ASSESSMENT PROGRAM

MOLDOVA

CORPORATE GOVERNANCE REVIEW OF THE MOLDOVAN BANKING SECTOR

TECHNICAL NOTE

SEPTEMBER 2014

This Technical Note was prepared in the context of a joint World Bank-IMF Financial Sector Assessment Program mission in Moldova during February and March, 2014, and overseen by the Finance and Markets Global Practice, World Bank and the Monetary and Capital Markets Department, IMF. The note contains technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at www.worldbank.org/fsap.

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Background: About the Bank Governance Review

The definition of corporate and bank governance

Corporate governance is commonly defined as the structures and processes for the direction and control of corporations, specifying the distribution of rights and responsibilities among the main participants in the corporation and spelling-out the rules and procedures for making decisions on corporate affairs.[1] Specific to banks, corporate governance is defined as the manner in which the business and affairs of banks are governed by their boards and senior management, which affects how they: (i) set corporate objectives; (ii) operate the bank's business on a day-to-day basis; (iii) meet the obligation of accountability to their shareholders and take the interests of stakeholders into account; (iv) align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations; and (v) protect the interests of depositors.[2]

The importance of corporate governance

Improving corporate governance can serve a number of important public policy objectives. Over the years, the importance of corporate governance has been highlighted by an increasing body of academic research. Studies have shown that good corporate governance practices have led to significant increases in economic value-added of firms, higher productivity, and lower risk of systemic financial failures for countries.[3]

Why good corporate governance matters for banks

Implementing good bank governance is of particular significance in creating a robust and stable banking sector in support of sustained financial and private sector development, and economic growth. Indeed, banks:

- Manage a significant portion of a nation's wealth through savings and must therefore be governed appropriately in order to uphold the public trust; if governed poorly, people's livelihoods could be at stake, potentially turning public opinion against current political leadership.
- Provide the preponderance of financing for the great majority of enterprises and individuals, particularly in emerging markets; therefore, the strength and capacity of banks take on greater importance in terms of funding economic growth.
- May well be expected to make credit and liquidity available in what are likely to be difficult market conditions in the years ahead.

With this in mind, it is important to note that banks generally have specific governance challenges and complexities since they take on significant volumes of risk-bearing assets. Hence, weak risk management frameworks and internal controls can cause severe and rapid financial

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1 The Organization for Economic Cooperation and Development (OECD): OECD Principles of Corporate Governance; 2004.

2 The Basel Committee on Banking Supervision: Principles for enhancing corporate governance; October 2010.

3 Corporate Governance and Performance Around the World: What We Know and What We Don't. Inessa Love, The World Bank Group, June 2008.

crises. The collapse of a single bank cannot only destroy shareholder value but also value for its depositors and may require a costly bail-out or liquidation by the authorities (and ultimately the tax payers). Ensuring that banks are well governed is thus of central concern to not only banking regulators, but to the Government more broadly and other stakeholders.

These country-specific and more general bank-related risks make well developed governance frameworks and practices of banks in Moldova a key condition for financial market stability, judicious credit allocation, and growth.

Objective and scope of this Bank Governance Review

This Review was prepared at the request of the National Bank of Moldova (NBM). It presents the setting and the circumstances for the development of governance policies and practices in the Moldovan banking system and reviews the effect of existing governance policy and practices on the oversight of banking sector related risks and prudential supervision.

The objective of this Review is to help strengthen the corporate governance practices of banks in Moldova. Specifically, it intends to:

- Further legal and regulatory reforms in Moldova based on the enclosed recommendations.
- Enable the NBM to increasingly rely on the relevant internal and reporting systems in those banks that have demonstrated better management and controls, therefore allowing supervisory resources to be directed toward troubled institutions and where needed the most.
- Promote corporate governance reforms in individual institutions, thereby enhancing the soundness of a specific bank.

The Review focuses on the overall banking sector. The scope of the Review includes:

- A review of the: (i) legal and regulatory framework, (ii) corporate governance practices of banks, and (iii) enforcement framework vis-à-vis a set of benchmarks based on internationally recognized good practices in bank governance;[4]
- A set of policy recommendations for the NBM on how to improve upon corporate governance in Moldova; and
- An action plan on how to implement the Review's policy recommendations and effect reforms.
- An Annex on the recent raider attacks that have affected the Moldovan banking sector. Since these raiders are the result of legal and institutional deficiencies beyond the banking sector, it was decided to document and map the problem in a separate note and include it as an Annex to the main bank governance report.

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[4] The benchmarks are heavily based upon the Basel Committee's 2006 Guidance on "Enhancing Corporate Governance for Banking Organizations" and the 2010 "Principles for enhancing corporate governance", as well as inputs from public documents issued by a number of supervisory agencies, rating agencies, and international institutions such as the Organization for Economic Co-operation and Development (OECD), European Union, Asia Pacific Economic Committee (APEC), International Finance Corporation (IFC), and the World Bank itself.

Bank Governance Review Methodology

The Review Methodology was developed in response to requests by World Bank client countries to evaluate and communicate governance risks potentially affecting the performance and stability of their banking sectors. As such, the Review Methodology approaches bank governance from the perspective of a risk based policy framework that is key for the comprehensive assessment of system vulnerabilities.

The Methodology is based on the Basel Committee's Principles for Corporate Governance in banking institutions and also grounded in best practices emanating from the banking industry as a whole and World Bank experience. Using a set of focused questionnaires, a survey of a sample of banks is conducted. A high level review of the country's bank supervisory process is also performed, focusing on the supervisor's emphasis on board and management oversight and risk issues. The Basel Committee's 14 Principles on Corporate Governance are listed in Annex 2. For more detailed presentation and explanation of these Principles, see "Principles for enhancing corporate governance", Basel Committee, October 2010, at http://www.bis.org/publ/bcbs176.htm.

Acknowledgements

The review team conducted its field work in February 2014, as part of the joint World Bank – IMF Financial Sector Assessment Program (FSAP) Update. During the mission, it met with a number of market participants. To understand the nature of existing governance practices and to gain a deeper understanding of the systemic issues in bank governance, the review team, in coordination with the National Bank of Moldova, surveyed all Moldovan banks and met with five commercial banks which represent approximately 70 percent of total bank assets. The team conducted extensive interviews, following up on the responses to previously distributed surveys. The debriefings with the banks included meetings with CEOs, board members, internal auditors, financial officers, and representatives from the compliance and risk management units. The team also met with the National Bank of Moldova and its supervisors.

The Report reflects technical discussions with the above entities as well as other relevant stakeholders whom the FSAP mission would like to thank for their time and invaluable insight into corporate governance practice in Moldova.

The FSAP mission would like to expressly thank the National Bank of Moldova for its support and help in organizing meetings with key stakeholders. The information received on the legal and regulatory framework, supervisory and enforcement regime, as well as current corporate governance practices was indispensable for the development of the Review.

The Review was conducted by Laura Ard, Lead Financial Sector Specialist (Corporate Governance Group) and Jean Michel Lobet, Senior Financial Markets Specialist (Corporate Governance Group) with additional inputs from Ghenadie Coltelnic, World Bank Office Moldova, Armine Khachatryan, IMF Moldova Office, and members of the World Bank – IMF FSAP Team subsequent to this review.

Acronyms

BCBS	Basel Committee for Banking Supervision
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGC	Corporate Governance Code
CoB	Chairman of the Board
FSAP	Financial Sector Assessment Program
GA	General Assembly (meeting) meeting of shareholders
GDP	Gross Domestic Product
IAS/IFRS	International Accounting Standards/International Financial Reporting Standards
IFC	International Finance Corporation
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
IFRS	International Financial and Reporting Standards
JSC	Joint Stock Company
JSCL	Joint Stock Company Law
LFI	Law on Financial Institutions
MoF	Ministry of Finance
MDL	Moldovan Lei
NBFIs	Non-bank financial institutions
NBM	National Bank of Moldova
NCFM	National Commission of Financial Markets
NPLs	Non-Performing Loans
NSD	National Securities Depository
OECD	Organization for Economic Cooperation and Development
UBO	Ultimate Beneficial Owner
WBG	World Bank Group

Executive Summary

The banking sector in Moldova is in the midst of structural changes with worrisome corporate governance issues at the core. Corporate governance is at the center of a stable and profitable banking sector which is essential to support economic growth and productivity. However, the banking system in Moldova suffers from critical governance weaknesses which the National Bank of Moldova (NBM) has been unable to effectively address. A small number of individuals have gained control of some of the largest banks in the country through illicit schemes. Changes in control have escaped NBM evaluation and fit and proper vetting thereby allowing veiled parties to operate in the country's vital financial sector with unclear and dubious intentions. Bank customers and the public are unable to identify the entities they are entrusting with their savings. Furthermore, changes in control have resulted in questionable activities by banks, potentially putting their condition and long term performance at risk. As in other countries, this bodes poorly for the soundness of the Moldovan banking system and the stability of the financial sector as a whole.

The illicit schemes used to gain control of the majority of the banking sector's assets have involved "raider attacks" by unidentified individuals whose subsequent, *de facto*, related party transactions have caused the deterioration of bank balance sheets. Individuals looking to take control of Moldova's financial institutions have used raider attacks to expropriate minority shareholders. These illicit acts have involved the judicial system, bailiffs, and share registries. As a result, close to 80 percent of the Moldovan banking sector and 70 percent of the nonbank financial sector are controlled by two or three undisclosed individuals. Since ultimate beneficial owners (UBO) cannot be identified, related-party transactions cannot be effectively monitored. Several of the subject banks have experienced phenomenal asset growth and substantial increases in nonperforming assets apparently associated with new, *de facto* related party credit exposures or with parties who cannot be identified and who have little or no operating / financial background. Experience consistently demonstrates that related parties who do not act in the best interest of the bank (and therefore the public) and who engage in abusive banking practices are a leading cause of institutional weaknesses, and many times failure.

The recent changes in controlling ownership have resulted in nontransparent appointments of board members and CEOs. This has led to substantial blurring of the roles and responsibilities of ownership, oversight (board), and management, resulting in no clear accountability. All banks indicated that the controlling shareholder nominates and appoints board members resulting in "shareholder boards" that have as their primary goal representation of the owner(s). There are no independent board members and boards have yet to conduct self-assessments of their performance and activities. Furthermore, the Law on Financial Institutions (LFI) and the Joint Stock Company Law (JSCL) allow the role of bank boards to be determined by each bank's board charter rather than enumerating the boards' responsibilities in law or in regulation. This regulatory flexibility can facilitate and bias board actions to fulfill the owners' interests rather than to act in the best interest of the bank and external stakeholders.

Boards lack objectivity and independence, and are not well qualified to oversee financial institution operations. Many board members appear to be selected based on their political or business affiliations and visibility and are described in terms of the shareholder or shareholder group they represent. Some members, as well as executive management, may hold board or executive positions in other institutions in the economy that may create the appearance of a conflict of interest, and few board members have substantial financial institution experience. Members are appointed for a term of 4 years, but they can be renewed an unlimited number of times which often results in a loss of current, more objective contributions.

Given the current configuration of banks' governance structures and the prevailing role of the controlling shareholders in the largest banks, boards are not fulfilling their proper role of strategic planning, guidance, and oversight. Boards are more focused on quality control, reviewing detailed changes to policy, reviewing all bank policies annually, and monitoring credit activity reports. Some strategic planning is conducted, but it is largely focused on growth without sufficient attention paid to the control environment as evidenced by the under-development of critical risk control and internal audit functions. Board audit committees do not exist; instead, the Censor Committee, appointed by the shareholders meeting, is often referred to as the audit committee. However, it does not constitute a working arm of the board since it reports to the shareholders meeting and, therefore, deprives the board of an independent mechanism through which it can ensure that its policies and procedures are being effectively implemented and that controls are sound. No other board committees exist to assist in more technical and demanding matters.

The legal and institutional corporate governance framework in Moldova is weak. The JSCL and the LFI do not adequately define related parties, regulate disclosure requirements, or enumerate the basic roles and responsibilities of banks' directors, including boards. Banks are also required to adopt a corporate governance code based on the guidance provided by the national corporate governance code. However, few banks appear to pay close attention to or disclose their compliance with this code. In addition, the judicial system has little, if any, financial sector expertise, including that involving corporate governance issues in financial institutions.

The NBM and the National Commission of Financial Markets (NCFM) are not able to effectively address the governance weaknesses and ownership issues in the financial sector. In a well-balanced and properly functioning financial system, the regulator-supervisor is empowered and properly resourced to ensure safe and sound institutions capable of supporting economic growth. However, in Moldova, the NBM, as supervisor of the banking system, is substantially blocked from performing its role. The Constitutional Court significantly curtailed the powers of the NBM in an October 2013 ruling reducing its administrative powers. As a result, efforts by the NBM to *inter alia* address changes in control, require disclosure of UBOs, and take other actions have been blocked to the ultimate detriment of the safety of the banking system.

Sound corporate governance is first and foremost dependent upon the motivations of owners and the resultant business culture they instill through their selection and appointment of board members. If owners and board members have corrupt motives, their oversight and direction will not instill balanced incentive structures which ensure safe and sound bank operations and ultimately, support economic growth. In Moldova, a few actors control the majority of the banking system. They demonstrate dubious motives by acting obscurely through others and through companies to own and control important banks. These actions create a system that is held captive to serve the needs and pleasures of a few at the expense of many: the depositors, general public, and ultimately, the taxpayer. This puts financial stability at risk.

Main Findings

A. Market Setting, Risk Factors, and Governance Culture

1. The Moldovan banking sector has grown rapidly since the country transitioned to a market economy in 1991. Although Moldova is a small country, the number of banks has been high with respect to the size of the population; by 1998, close to 23 banks had been established. Thereafter, however, by 2010 the number declined to 16 as a result of increased competition, financial crises, and higher capital and stronger operational requirements required by the NBM.

2. Today, there are 14 commercial banks operating in the country. Banking sector assets total MDL 76 billion (approx. USD 5.6 bn) and represent approximately 93 percent of total financial sector assets at the end of 2013. The non-banking financial sector is underdeveloped and is comprised of insurance companies, microfinance institutions, and saving and credit associations. The financial sector as a whole is approximately 73 percent of GDP (at end-2013).

3. Bank ownership is highly concentrated. Market participants widely acknowledge that 77 percent of the banking system is controlled by a small number of individuals who may be acting in concert, and who also have important stakes in other parts of the financial system and infrastructure. Competition is limited, and connected lending and large exposures represent significant risks to the system. Moreover, in some cases cross-border exposures are substantial and resemble flow of funds that are indicative of money laundering.

4. Since 2010, Moldovan banks have been victims of raider attacks[5] which have resulted in surreptitious changes in ownership control. These attacks are having adverse implications on the Moldovan economy (see Annex for more details on raider attacks). In countries where property rights are not guaranteed by the law or the law is not enforced, the private and financial sectors cannot grow in a sustainable manner. This in turn has implications on the potential of the economy to attract investments, grow, innovate, and generate new jobs. Moreover, financial stability is also at stake. Raiders are now using the banking system to finance activities that are not in the best interests of the banks, shareholders, depositors, or the government. If such activities ultimately threaten the viability of some of the larger institutions in the country, the ramifications would be costly for the country's budget (and taxpayers), depositors, and creditors, and financial stability as a whole. Ultimately, the economy itself is at risk, as international and historic experience has demonstrated the economic crises stemming from financial crises are often the most severe both in depth and longevity.

[5] A raider attack, in the Moldovan context, occurs when an individual or organization takes over control of a company fraudulently. For example, a common method in Moldova is forging loan documents indicating that shares in a company are pledged as collateral, and then forging documents indicating that the loan is in default. A court decision is then obtained, typically without the legitimate shareholder being able to defend him/herself or even being notified of the court case, and the shares are transferred by one of the 11 independent share registries."

B. Regulatory and Institutional Framework

5. The corporate governance framework for banks is set forth by the JSCL and the LFI. The JSCL sets forth shareholders' rights, structure and liability of the members of the board of directors, structure and responsibilities of the censor committee, and regulation of related-party transactions. The LFI outlines, *inter alia*, the requirements to become a shareholder or a board member of a bank, conflict of interest regulations, and disclosure requirements. Article 24 also charges the banks' directors with "a fiduciary obligation to the bank ….. to put the interests of bank and clients above their own pecuniary interests".

6. Banks are incorporated as Joint Stock Companies (JSC), and since according to Moldovan law they are "public interest entities," they are also required to register their securities on the Moldova Stock Exchange.[6] There are no specific restrictions on ownership by local or foreign nationals. However, according to Article 15 (1) and 15-2 (1) of the LFI, the acquisition of stakes above 5 percent must be reported to and approved by the NBM. In case the NBM rejects the transaction, the shares must be sold within 3 months.

7. The JSCL and LFI do not adequately enumerate the basic roles and responsibilities of banks' directors, including boards. Legislation has yet to fully address board responsibility to set business strategy, risk appetite and the attendant controls, and institutional and managerial performance monitoring. Requirements for the roles of ownership, board, and management should be well defined with direction for separation of duties, unambiguous reporting lines, and clear accountability.

8. Banks are also required by the NBM to develop their own corporate governance code based on the guidance provided by the national code. However, few banks disclose compliance with either. Moreover, the national code falls short of good practice, failing to provide proper guidance on good corporate governance. For example, the code does not provide guidance on the appointment of independent directors or evaluation of board members and is silent regarding the duties of board members. In addition, the code does not provide a comprehensive definition of conflicts of interest and how transactions with related-parties should be approved and disclosed (internally and externally).

9. The Moldovan judicial system is perceived as being corrupt. Market participants, government officials, and stakeholders have raised concerns about the levels of corruption in the

[6] According to Moldovan legislation, public interest entities are financial entities, investment funds, insurance companies, private pension funds, and entities whose shares are traded on the stock exchange. Since banks are public interest entities, purchase and sale of shares can only take place via the Moldovan Stock Exchange.

judiciary and the absence of rule of law. Judges and bailiffs have played key roles in the raider attack schemes (Annex) that have taken place since 2010. However, government authorities have not taken concrete actions to address the weaknesses of the judicial system.

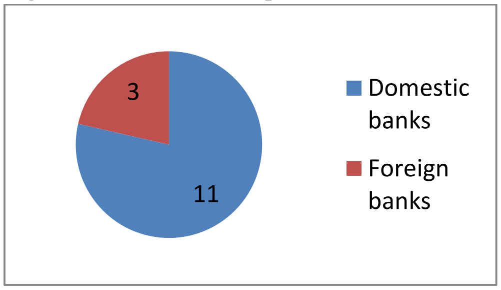
10. The NBM has insufficient powers to effectively perform its supervisory role and address financial institutions' governance weaknesses. An October 2013 Constitutional Court ruling significantly reduced the administrative powers of the NBM. According to the ruling, any administrative decision taken by the NBM can be appealed, and while the appeal process is on-going, the administrative decision can remain suspended until a final decision by the courts (except for issues related to liquidations and removal of operational licenses of banks). Actions taken by the NBM to block shareholders that it determined were acting in concert have been subsequently challenged and suspended. Notwithstanding such actions, shareholders in one bank (all holding under the 5 percent threshold that triggers NBM evaluation) subsequently sold their shares to offshore entities on which information is limited, thereby restricting the NBM's ability to vet and determine their inter-relationships. Furthermore, a decision by the NBM to restrict cross-border interbank credit exposures has also been challenged and suspended. Moreover, despite the large number of obscure ownership transactions over the last two years, the NCFM, responsible for overseeing registration and transfers of shares in listed banks, has not initiated investigations or raised concerns. Each of these situations highlights the lack of respect for the rule of law and the crucial need for effective and empowered regulatory bodies in a safe and well-functioning financial sector.

11. The ownership of share registries is not transparent. There are eleven share registries which are privately owned JSCs. Similar to the banking sector (see next section), the ownership of these registries is not transparent. Share registries are supposed to be independent institutions; however, since UBOs cannot be identified, the risk of conflict of interests is very high. For example, according to local stakeholders, the registry contracted by two of the largest banks is owned by the UBO who recently acquired a controlling number of shares in the same banks through raider attacks. The NCFM, the entity in charge of providing operational licenses to these registries, does not perform fit and proper reviews upon subsequent change in the registries' ownership, nor does it rigorously vet board members and CEOs.

C. Structure and Ownership

12. The banking sector is composed of 14 joint stock commercial banks (figure 1) with assets valued at approximately 73 percent of GDP. All the banks in Moldova are privately owned except for a state shares in Banca de Economii (BEM) (33.3% + 1 share) and Eurocredit Bank (21%). Three banks are owned by foreign banks: Mobias Banca (Societe Generale), Exim Bank (Grupo Veneto Banca) and Banca Comercială Română Chișinău S.A (Romania Commercial Bank).

Figure 1: Bank Ownership Structure



Source: National Bank of Moldova

13. Banks' ownership structures are not transparent, preventing the NBM, the public, and investors from assessing the owners. The largest banks in the system are owned by multiple shell companies, each of them owning less than 5 percent of voting shares.[7] For example, Unibank is owned by 21 companies with shareholding stakes that range from 1 percent to 4.9 percent. Since 2010, the ownership structures of major Moldovan banks, including the largest six institutions, have been the target of dramatic shareholder changes.[8] Sixty percent of the shares of Banca Sociala changed ownership in the last six months. The shares were transferred in small blocks of less than 5 percent each. BEM increased its capital through the issuance of new shares where the government's 56 percent participation was diluted by 22.7 percent. Again, the shares were acquired piecemeal by multiple companies. The ownership structure of Agroindbank has also changed. Today, all the shareholders of Agroindbank own stakes of less than 5 percent.

14. These ownership structures are the result of complex schemes by the UBOs to circumvent the vetting powers of the NBM. According to Article 15 of the LFI,[9] the acquisition of more than 5 percent of the shares of a bank must be reported, and the NBM has the power to approve or disapprove the acquisition. In case of acquisition of significant stakes of a bank, the NBM conducts a complex fit and proper assessment of the potential buyers (e.g. affiliations, conflicts of interest, etc.). By avoiding the NBM review process, UBOs can remain anonymous.

15. Most of the recent ownership changes have not been conducted in a transparent manner. Individuals looking to take control of Moldova's financial institutions have used schemes (raider attacks) to expropriate minority shareholders. In most of the instances, the shares

[7] As for many neighboring countries, the identification of UBOs is problematic in Moldova. Most of the shell companies that own Moldovan banks are incorporated in other jurisdictions, including the United Kingdom, Lebanon, Kazakhstan, and the Russian Federation. When asked to disclose the identity of UBOs of these shell companies, CEOs and board members are, generally, unable to provide a concrete answer.

[8] As of end 2013, these six banks constituted about 77 percent of the total banking assets in the Moldovan market.

[9] As amended by the Moldovan Parliament in March 2013.

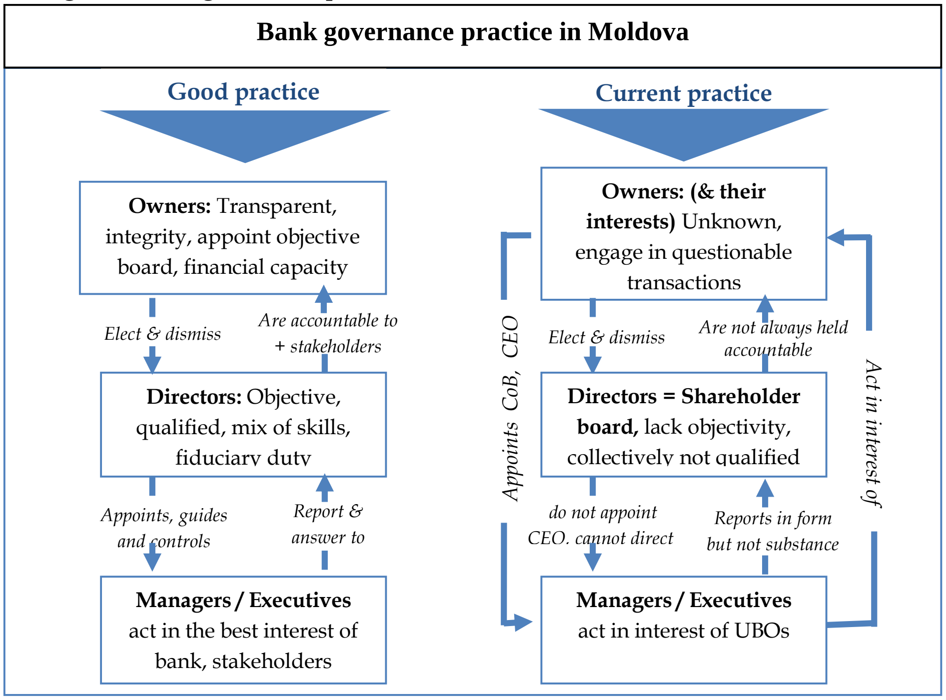
were expropriated under the format of fraudulent debt enforcement procedures. These illicit acts have involved the judicial system, bailiffs, and share registries. As a result, market participants confirmed that close to 80 percent of the Moldovan banking sector and 70 percent of the nonbank financial sector are controlled by two undisclosed (but widely acknowledged) individuals. For a more detailed discussion about the raider attacks, see Annex.

16. Since UBOs cannot be identified, related-party transactions cannot be effectively monitored. LFI Article 3 defines a related party as: persons holding control over the bank, members of the supervisory board (and their families), members of the executive board (and their families), members of the censor committee, and shareholders owning more than 5 percent of the shares of the company. According to the LFI and the JSCL, related-party transactions must be approved by the board of directors, and the interested parties must recuse themselves from the approval process, consistent with best practice. However, this approach is not working well in practice. First, since the majority of banks are owned by multiple shell companies holding less than 5 percent stakes, any transaction between the bank and its shareholders is approved as a normal transaction by the board or the CEO. Second, since UBOs (who are de facto controlling owners in several banks) cannot be identified, their affiliate companies and relations cannot be identified. Therefore, dealings with such parties, likewise, are approved as normal transactions by the board, CEO, or senior management group.

D. Board Function

17. The board of directors is the function where key responsibilities of a bank converge. Given that banks are considered special interest entities that play a key role in all economies, bank boards are charged with the public's trust to act responsibly and with integrity. Boards have special duties to act in the best interest of all stakeholders, not only the owners. The board must set the appropriate "tone at the top" through which it directs the manner in which the bank conducts its business - through strategic planning, risk parameters, and policies. It must set clear risk parameters within which management and staff execute the business plan. It must ensure key control functions are established and independent so that it can monitor the bank's existing and prospective risks, the overall success of its business strategy, and financial performance and soundness. As a result, the board must be composed of a balanced mix of skills and experience, must be objective, and must fulfil its fiduciary duty through prudently guiding the bank. The boards in Moldovan banks have yet to fulfil the full scope of their responsibilities (Figure 2).

Figure 2: Bank governance practice in Moldova



18. Lines and responsibilities between owners, boards, and management are overlapping and ambiguous, thus creating an environment conducive for owners to directly influence banks' daily operations for their own interest. Most banks have not effectively separated ownership from control and management, and therefore, boards lack the independence and objectivity to effectively oversee banks' activities. Shareholder changes in the largest banks have resulted in changes in control and subsequent changes in boards and key management positions, in particular the CEO. Unclear ownership masks the director nomination process and representation on boards, resulting in "shareholder boards" with no independent outside members to counterbalance and represent the interests of other stakeholders. In practice, few if any boards surveyed have an established set of criteria or requirements for prospective candidates.

19. Boards lack objectivity and independence, and many are not well qualified to oversee financial institution operations. In discussions with banks, board members were described in terms of the shareholder or shareholder group they represent. Many board members appear to be selected based on their political or business affiliations and visibility. Some members, as well as executive management, hold board or executive positions in institutions in the economy that create the appearance of a conflict of interest, and few have substantial financial institution experience.

20. Given the prevailing role of the controlling shareholders in the banking system and the resulting weak governance culture that they set, boards are not empowered to fulfil their proper role of strategic guidance and objective oversight of operations. Boards are typically more focused on lower level review processes rather than on strategic direction. Banks indicated that boards concentrate on quality control issues, review detailed changes to policy, review all bank policies annually, monitor credit activity reports, and approve exposures over 10 percent of capital. While most banks report that there is a strategic planning process in which the board is involved, they also report that it is largely focused on asset, customer, and revenue growth. In the current environment, planning is not sufficiently focused on risk strategy and risk control as evidenced by the under-development of critical functions such as independent risk management, compliance, and internal audit. Furthermore, boards are not made explicitly responsible, by law, for the truthfulness and integrity of their banks' financial reporting; nor are they held to account for fulfilling their fiduciary duty. Therefore, their focus on and recognition of the importance of critical control functions and the role they play in i) triggering board response to risk issues, ii) evaluating success of business strategies, and iii) accurate financial reporting, are minimized.

21. Board committee structures are non-existent and therefore, no mechanism exists to assist boards in more technical and demanding matters. Board audit committees do not exist; instead, the Censor Committee, appointed by the shareholders meeting, is often referred to as the audit committee. However, it is charged with a host of detailed checking activities so onerous that it likely cannot successfully accomplish the full agenda on an annual basis.[10] The JSCL allows delegation of the committee's oversight tasks to an external audit firm, but such an agenda might prove prohibitively expensive if performed by a qualified third party. This committee was originally designed to protect shareholders' interests but now is duplicative with other functions such as external audit, internal audit, risk management, and the risk and audit committees of the board, if they are all in place and functioning properly. Given that the Censor Committee reports to the shareholders, it does not constitute an arm of the board and therefore deprives it of a mechanism to ensure that its directives are being effectively implemented and that the control and risk environment is sound. No other board committees, such as board risk committees, exist.

22. Lacking a properly balanced governance structure and empowered board, significant decision making power has been vested in the Chief Executive Officer (CEO) position in most banks. CEOs are either appointed directly by the shareholders or by (shareholder) boards that directly represent the controlling owner (effectively the UBOs), further confusing the lines of responsibility and accountability (See Figure 3). Once the controlling owners appoint the

[10] Duties the Censor Committee is charged with include: establishing accounting procedures and controls for the bank, supervising compliance with those controls, auditing bank accounts and records, monitoring compliance with laws and regulations and reporting such to the board, and delivering advice to the board when requested. It must have no less than 3 members and must meet at least quarterly.

CEO, the lines of responsibility from the CEO to the board essentially are bypassed. As a result, CEOs are more obliged to represent and respond to the interests of the major shareholders who elected them. In all banks interviewed, important decision-making responsibilities were clearly concentrated in the CEO position rather than clearly held and executed by the board. Furthermore, boards of several banks are not fully constituted; some do not have the requisite number of members, and some board members have not sought or received approval from the NBM. As a result, many banks are operating without full boards or with board members that have not been approved by the NBM, allowing further concentration of decision making power in the CEO.

23. Banks with recent control changes and ambiguous ownership structures have engaged in aggressive business activity, including transactions with suspected related party entities and with customers that are new (lacking operations experience) and/or ambiguous. Several such banks have engaged in high-cost funding strategies and (apparent) rapid asset expansion (lending to ambiguous parties, foreign interbank placements, etc.). Deposit rates offered by some banks are substantially above current market rates in a quest to rapidly access high volumes of potentially volatile funding. This money is circulated through the financial system, including through offshore banks, and is ultimately routed to obscure borrowers. While most banks report profits, there are concerns around many banks' net interest margins, and therefore their true profitability and ultimately solvency, given their funding structures as well as their level of bad debts, some of which may be related-party exposures.

E. Risk Oversight

24. The development of risk strategy, effective risk oversight, and a sound control framework is one of the most critical roles for which bank boards are responsible. Independent risk oversight processes (internal audit, risk management, compliance) are an important instrument of the board to ensure that its strategies, risk thresholds, and policies are communicated, monitored, and respected. If boards are adequately empowered to set business strategy and the risk parameters necessary to accomplish that strategy, then the risk management function becomes an important tool for it to understand the success of its directions and the soundness of the institution. Having a strong risk management function allows the board, then, to discharge its duty to oversee the performance of the institution.

25. However, the value of these functions and a properly empowered board has yet to be fully embraced by owners, boards, and management. Further, the prevailing corporate culture casts doubt on the capacity of any of the internal review functions to perform their role, report to the board, or trigger appropriate board and management responses.

26. Reflecting the prevailing corporate culture and weak governance environment, proactive identification of risk and development of robust and independent risk management systems have not been a priority of boards and management. Banks have not yet established a fully independent function which identifies and monitors all risks. All interviewed banks have established a credit risk control function in the business line, consistent with the NBM's internal control regulation, which: i) provides a second opinion on credits going through the approval process; ii) monitors the status of booked credits; iii) prepares reports for management on the current portfolio condition; and iv) reports classification and other risk information to the NBM. The sophistication of the activity varies depending on management's emphasis on credit control. In one bank, this process has been further developed and automated and provides red flags on payment or collateral lapses. In other institutions, the process provides more of an opinion or credit analysis for the credit process rather than a formalized monitoring and reporting function. In all cases, the risk control function, rather than the business line, is responsible for reporting changes in credit classification.

27. Sound credit risk management (best) practices are typically constituted by a secondary surveillance function with a direct communication link to the board and which continually monitors and periodically tests portfolio credit quality. Given that the business line is, or should be, closest to the customer, it should be held responsible for monitoring the credit which it sources and books and also be held responsible for flagging credits which start to deteriorate – at the earliest stages. Likewise, credits should be flagged based on real economic deterioration of the borrower rather than waiting for such exposures to be identified ex post (i.e. when they become delinquent) so that timely and active remedial action can be taken by management to minimize risk of loss. A concrete conflict of interest exists when the same unit is responsible for identifying credit deterioration and changing classifications while at the same time analyzing portfolio performance and acting as a surveillance tool for management and the board. A strong governance culture charges all in the institution -- business line / relationship officers, risk surveillance, and internal audit -- with ownership of risk. Strong ownership of risk (credit and other risks) is when all in the institution understand and know what risk is, understand the (prudent) risk parameters and business strategies set by the board and management, and communicate risk positions and potential risk issues within the institution and with the appropriate persons or units. In Moldova, given the motivations at the top of some of the most important banks, "ownership of risk" is not a well-constituted concept or practice.

28. Operational and interest rate risks, similarly, are areas of concern. The level of operational risk in the banking sector is high, in part due to a number of manual processes and the need to more extensively employ the "four eyes principle". No bank has yet mapped its operational risks.

30. There is currently no NBM directive requiring banks to establish an independent risk management function that reports to the board. The regulation on internal control requires that the various risks (credit, interest rate, foreign exchange, liquidity, operational) and compliance with internal policy be continually monitored. Credit risks, more specifically, are required to be monitored by a separate credit control department, albeit in the business line, which reports to the management credit committee.

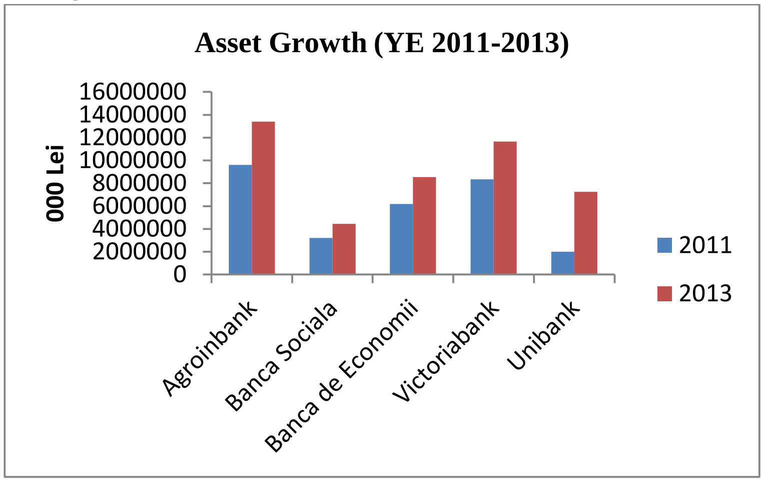
F. Internal Audit

31. While all banks report they have an internal audit function that reports to the board, as required by the LFI and Regulation on Internal Control Systems, in practice the functions appear to lack adequate independence. Consistent with the law, banks indicated that the head internal auditor is appointed by the board and that the audit department reports to the board. However, in 4 out 5 banks interviewed, the CEO is responsible for the auditor's performance evaluation and salary level. Furthermore, although auditors periodically report to the board, no banks indicated that the auditor meets with the board without management present. Three of the five banks interviewed did not have a permanent head auditor but only an acting head. Furthermore, discussions with banks indicated that the audit department typically does not have access to all subsidiary or affiliate operations of the bank.

32. The staffing and professional requirements of banks' audit departments reflect the broader auditing profession in Moldova which has been slow to develop. Most bank audit departments are run by auditors with little professional experience. In some instances, the audit departments are run by lawyers. The professional requirements for an internal auditor appear light compared to EU member states– for example, major Moldovan banks require audit staff to have a bachelor's degree in finance and at least 3 years of professional experience, and require chief auditors to have a bachelor's degree in finance and 5 years of professional experience. Banks, in general, have not taken the initiative for ongoing, accelerated training for audit staff. To improve this situation, the NBM is periodically organizing seminars and training for the auditors.

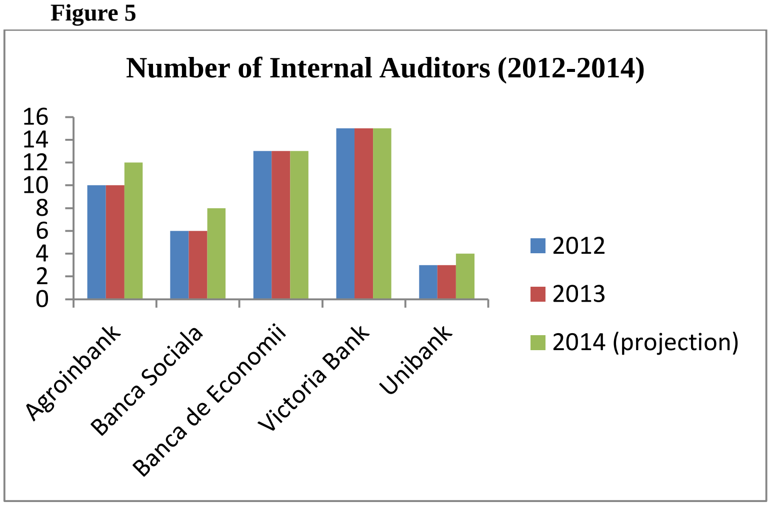
33. Virtually all internal audit departments suffer from understaffing. Crucially, audit staffing has not kept pace with the rapid expansion in many banks (See Figures 4 and 5). Discussions with auditors indicated that the departments may conduct up to 50-60 audits annually. Given the level of staffing and the growth of many banks as well as a relatively low level of experience, departments are not likely to have the resources necessary to comprehensively cover bank operations with a high level of quality.

Figure 4



Source: National Bank of Moldova

Figure 5



Source: WBG Bank Governance Survey

G. External Audit

Principle 9: The board and senior management should effectively utilize the work conducted by internal audit functions, external auditors and internal control functions.

34. All banks are required to receive an external audit by a qualified firm, and the external audit process is well established with clear guidelines. According to Article 34 of the LFI banks are required to appoint an external auditor acceptable to the NBM. International audit firms are present in the Moldovan market and have worked extensively with local banks over the last 10 to 15 years. However, regulation does not encourage the firms (or the partner) to rotate or prohibit them from providing non-audit services. In one of the largest banks, the firm was the external auditor for more than 14 years.

H. Disclosure and Transparency

Principle 14: The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

35. Non-financial disclosure by banks requires significant improvement. Banks are required to produce annual reports according to IFRS; however, non-financial disclosures are poor. As indicated above, UBOs and ownership structures (and therefore related-party lending) are not disclosed, leaving depositors and the public without an understanding of who the owners are or an opportunity to evaluate them. Consistently, disclosures in annual financial reports or on individual websites do not present related party transactions, board members and biographical information, director and senior management remuneration, or the nature and compliance with the bank's corporate governance code.

Policy Recommendations

<table>
<tr><th colspan="2">Legal, Regulatory and Supervisory Recommendations</th></tr>
<tr><th>Priority</th><th>Recommendation</th></tr>
<tr><td colspan="2">(High Priority: Address within one year; Medium Priority: Address 1-3 years)</td></tr>
<tr><td>High</td><td>Regulatory and Supervisory Powers:
Amend the Law on the National Bank of Moldova and Law on the NCFM, and other legislation as required, to provide NBM and NCFM with the ability to enforce supervisory and regulatory actions in a timely manner (addressing, for instance, problems ensuing from the Constitutional Court rulings).</td></tr>
<tr><td>High</td><td>Bank Ownership - Role of the NBM:
The NBM should continue to use its authority to block shareholder actions if such shareholders have obtained effective control by circumventing the NBM's vetting (fit and proper) process or are determined to be acting in concert.
All bank shareholders (direct, indirect, UBOs) should be required once again to disclose themselves to the NBM and go through the NBM's vetting process to ensure effective disclosure and to filter those who should not be active owners of critical institutions in the country.
An adequately resourced, separate unit within the NBM should be established to monitor bank ownership and UBOs.</td></tr>
<tr><td>High</td><td>Strengthening the LFI:
The LFI (or secondary legislation) should explicitly set out the basic roles and responsibilities of the key functions of a bank: ownership, board oversight, and management. The role of the board should not be relegated to the bank's board charter, particularly given that the board has a fiduciary duty to the bank as stated in the LFI itself.
The LFI should explicitly state that the CEO should be appointed by the board and that the CEO is responsible and accountable to the board. The board should be responsible for the CEO's performance evaluation as well as his/her dismissal if and when necessary.
The LFI should strengthen the definition of related party. Many de facto related parties hide under the 5% threshold to escape NBM vetting and to remain anonymous. Furthermore, many of these entities are tied back to the UBOs. The NBM should be provided, in the LFI, the authority to identify and name related parties that otherwise escape the spirit or intent of the Law.
The LFI should place the burden of proof that a given party, or set of parties, are not inter-related. Otherwise, if such proof is not convincing to the NBM, the NBM has the right to take remedial action.</td></tr>
<tr><td>Medium</td><td>Corporate Governance Code/Regulation for Banks:

The NBM should lead a collaborative effort (among banks and market participants) to develop a corporate governance regulation for the banking system. The regulation should leverage existing legislation but address the gaps that exist. It should holistically convey the nature and objectives of sound governance and enumerate key requirements for sound governance.
Training for bankers and the NBM should be conducted, in part to explain the benefits and repercussions of implementing or not implementing the regulation.
The NBM should require banks to evaluate the status of their own corporate governance against the new regulation and prepare reform plans that are forwarded to the NBM. The NBM should convey to the banks its process of monitoring and follow up.
The regulation should address, inter alia:
✓ Expectations for a strong governance environment and risk culture, i.e. the need for the bank's key parties (owners, board members, management) to act with integrity and in the best interest of all stakeholders, not only owners.
✓ The proper, distinct roles of ownership, board oversight, and management to establish the responsibilities and accountabilities of each function. The separation of ownership and control should be clearly set out.
✓ Board professionalism, objectivity, and independence. The code should encourage banks to identify ways to enhance board professionalism including identifying ways to attract the</td></tr>
</table>

	necessary talent to boards, particularly independent board members – possibly from abroad. Over the medium term, the proportion of independent, qualified members should be increased. ✓ The role and importance of a strong strategic planning process at the board level. The process should explicitly address the risk considerations of business plans and projected growth areas, the adequacy of existing risk and internal control functions, and the need to correlate risk management and internal audit capacity with growth. Success and performance indicators should be established. ✓ The requirement for independent control functions that are adequately staffed and resourced and which can serve as a tool for the board to monitor the management, condition, and performance of the bank. ✓ Improved transparency and disclosure of financial and nonfinancial information – throughout the year as well as annually. ✓ The requirement to rotate audit firms – or lead audit partners assigned to the subject bank - to help preserve the independence of the external audit function. ✓ The requirement for boards to conduct a self-assessment of the board function and its effectiveness at least annually. Outside parties might be considered for this as well. ✓ The requirement for boards to evaluate the overall corporate governance structure and function periodically. Outside parties might be considered for this as well.
Medium	**Targeted Supervisory Corporate Governance Assessments:** The NBM should design and begin targeted reviews of corporate governance structures and activities in banks. In the future, a "horizontal" approach whereby all banks receive a targeted corporate governance review within 6 months to 1 year should be conducted. The overall results should be compiled and plans to reform and upgrade clearly communicated. Publication of at least summary results should be considered.
Medium	**Risk Management Regulatory Guidance:** The NBM should issue guidance or a regulation which enumerates the fundamental requirements for good risk management – for all risks. The independence of the risk unit as well as the processes, reporting lines, qualifications, etc. should be more fully addressed. The guidance should require a specifically designated chief risk office (CRO) commensurate with the size and complexity of bank operations.
High	**Judicial System (including the bailiff system):** An extensive review of the judicial system is imperative with a time bound action plan produced that assigns responsibilities and accountability for implementation. It should address, *inter alia*: • increasing the entry standards for the profession of judge; • increasing the wages of judges; • reviewing the existing codes of conduct to increase the liability regime of judges in case of corruption; and • ensuring that the right enforcement structures are in place to secure the independence and transparency of the judicial system. A similar strategy should be followed regarding the bailiff system. Finally, this reform process must be accompanied with intensive training on financial and corporate law issues to increase the specialization of certain judges.
High	**Share Registration and Record Keeping Processes:** Currently, eleven share registries are providing share registration and record keeping services to thousands of JSCs in Moldova. Similar to many of the Moldovan banks, ownership of share registries is not transparent, and market participants indicate that they have played a role in raider attacks. • All registries should be consolidated into a single entity overseen by an independent authority that can ensure better governance and transparency. • All registration responsibilities should be consolidated under a single independent authority so that roles, responsibilities and accountabilities cannot be confused. Splitting responsibilities among two or more entities would complicate and blur lines of responsibility, put the involved entities at potential risk

	of being charged for the other's (possible) mismanagement, and potentially allow for arbitrage or circumvention by other third parties.
Bank-Specific Recommendations	
Priority	**Recommendation**
Medium	**Board Member Training:** As a part of boards' ongoing efforts to remain abreast of current developments and issues within the financial sector as well as to gain additional insights into more technical aspects of the sector and their banks, members and senior executives should identify and attend (or host) periodic workshops and relevant knowledge updates on a regular basis.
Medium	**Risk Management:** ▪ Commensurate with the size and complexity of the bank, credit accountability systems should be implemented which require relationship managers to flag borrower issues early in the life of the credit. Risk management functions should serve as "second lines of defense" and evaluate, monitor, and report risk issues. ▪ Risk management should not be directly involved in the approval of credit. This compromises the unit's ability to independently flag risk concerns. ▪ Operational and market risks should be addressed (measured and monitored) by an independent risk management function. ▪ Risk control and management reporting lines to the board should be established; commensurate with the size and complexity of the bank, a chief risk officer should be appointed and his/her independence from the business line should be assured by the board. ▪ All control functions (risk management, internal audit, and compliance) should meet periodically with the board without executive directors or management present.
High	**Internal Audit:** Internal audit functions require substantial upgrade**:** • Independent reporting lines directly to the board should be emphasized. • The chief internal auditor should periodically, at least twice a year, report directly to the board without the presence of the CEO, other executive board members, or management. • The stature and authority of the chief internal auditor and audit department should be elevated and assured, including: ✓ filling vacant chief internal auditor positions in banks; ✓ board (or audit committee) appointment and board involvement if the chief internal auditor is dismissed; ✓ board-conducted performance evaluation for the chief internal auditor ; ✓ sufficient remuneration of the chief internal auditor and audit staff; ✓ adequate resources including staffing and systems; ✓ appropriate organizational positioning of the audit department; ✓ auditing access to all areas of the bank; and ✓ auditing risk management and compliance functions as well as subsidiary operations • Audit planning should also consider the business activity planned in the strategic plan. ▪ Audit staff should receive periodic and ongoing training.
Medium	**Compliance Function**: The development of formalized compliance functions, consistent with international standards, should be more actively pursued.
High	**Related-Party Transactions:** • Bank boards should be held responsible and accountable by the NBM for identifying their related parties, including the UBOs and their interests and affiliated operations. • Banks should likewise be responsible for implementing a methodical system through which related parties are identified, flagged in the course of banking business, evaluated, and monitored.

	• The NBM should monitor these transactions and take appropriate action in case of violations.
Medium	**Disclosure and Transparency:** Disclosure standards should be upgraded. The credit risk identification process and requirements require strengthening (which impacts loan loss provisioning, capital accounts, interest accruals, earnings, etc.) in order to more accurately convey banks’ financial position. Nonfinancial disclosures are insufficient and should be expanded to address, *inter alia*: ✓ Related party transactions ✓ Board member and management biographical information ✓ Director and senior management remuneration (direct and indirect) ✓ Nature and compliance with the bank’s own corporate governance code

Annex 1: Raider Attacks on Major Moldovan Banks

Since 2010, the ownership structures of major Moldovan banks, including the largest 6 institutions, have been the target of dramatic shareholder changes.[11] Purchase and sale of shares of banks are common operations in today's global capital markets. However, when these operations have implications in the significant or controlling ownership structure of a bank, they must be evaluated and (dis)approved by the bank regulatory body, in this case the NBM.

Banks are "special interest entities" and are charged, in all economies, with the public's trust to safeguard depositor funds, the taxpayer, and ultimately, financial stability. Because of this special position and the role banks play in the economy, the banking regulator/supervisor is charged with the position of gatekeeper to the system to ensure that owners, particularly those who can influence and control the bank, are on an ongoing basis fit and proper and meet the high standards necessary to operate in this strategic sector. Furthermore, banks' ultimate owners and controllers must be disclosed and transparent to their stakeholders (depositors, public, taxpayers, regulators, supervisors, etc.) given their right to understand with whom they are ultimately doing business and who is operating in their country's economy.

Unfortunately, many of the recent ownership changes in Moldovan banks have not been conducted in a transparent manner and have not received NBM review and (dis)approval. As a result, shareholder changes have resulted, de facto, in changes in control and in subsequent changes in boards and key management which have impacted the nature of the bank's business and potentially, their safety and soundness.

In many cases, ownership was acquired piecemeal through stock market operations, in transactions just under 5 percent of the subject bank's capital, in order to intentionally circumvent the law and escape NBM vetting,[12] thereby accumulating significant controlling stakes in banks and the financial sector.[13] A closer review of the banks' shareholder structures indicates that the predominant ownership of many of these small stakes is a series of shell companies that, according to local stakeholders, have common ultimate beneficial owners (UBOs) who have remained anonymous. In other cases, more complex transactions occurred through public authorities, including judges, bailiffs and share registries, to expropriate minority shareholders. In the market, these are referred to as raider attacks.

These illegal transactions, conducted by entities (and ultimately, individuals) with ambiguous motives, can have serious implications for the economy. According to local stakeholders, certain of the UBOs have interests in strategic entities in the economy including banks, nonbank financial institutions (leasing and insurance companies), share registries and the judicial system.

[11] As of end 2013, these banks constituted more than 60 percent of the total banking assets in the Moldovan market.

[12] According to Article 15 of the LFI, the acquisition of more than 5 percent of the shares of a bank has to be reported and approved by the NBM. Law on Financial Institutions N. 550-XIII of 21-07-1995: http://www.bnm.md/en/law_fin_institutes

[13] Insurance companies have also been subject to such attacks.

This, in conjunction with a regulatory and supervisory regime that has been weakened by the Constitutional Court rulings, has the potential to place the country's economic and financial stability and security at risk.

Raider attacks on commercial joint stock companies

Raider attacks are also affecting other sectors of the economy. Stakeholders conveyed that one bank in the system has been gaining control of commercial JSCs through similar schemes. The targeted victim is a customer of the bank, identified via their confidential records submitted to the bank in order to obtain a loan. Similar to the previous method, a false loan contract issued by a third party is at the nexus of the scheme. The court declares the company bankrupt, and the bank joins the liquidation procedure as a creditor. Finally, the bank takes control of the company during the liquidation process.

Impact

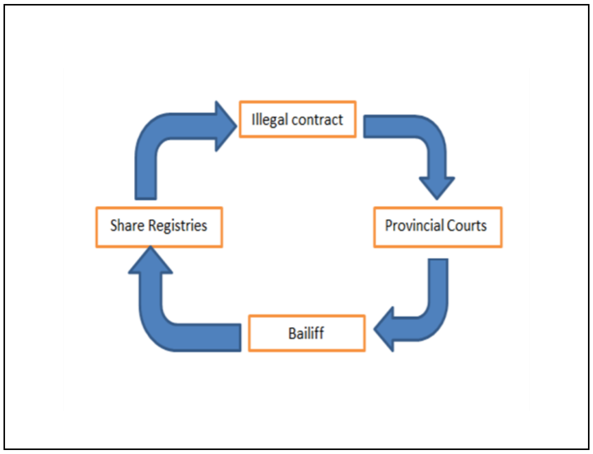
The above referenced raiders now have access to the banking system through which to finance activities that may not be in the best interest of bank clients, depositors, the public, shareholders, the taxpayers, and other stakeholders. Some banks are offering aggressive market rates on deposits to accumulate high volumes of potentially volatile funding. This money is circulated through the financial system, including through offshore banks, and is ultimately rerouted to obscure borrowers, including probable related party interests. Given the volume of flows involved and the channeling to illiquid assets, the liquidity positions of the subject banks are likely encumbered, introducing potential systemic risk to the financial sector in the case large funds providers curtail their exposures to these banks. If one bank experiences dire funding difficulties and is unable to honor its obligations, a contagion of defaults may result. This would bring with it serious, costly ramifications for sector stability and the country's budget (and taxpayer) in case depositors need to be made whole.

Further, raider attacks can have multiple, adverse implications for the Moldovan economy. First, in countries where property rights are not guaranteed by the law and institutions, private and financial sectors cannot grow in a sustainable manner. The lack of a transparent and predictable system reduces the opportunities for domestic and foreign investment. Therefore, this has implications on the potential of the economy to grow, generate new jobs, etc.

Description of the raider attacks

Raider attacks involve obscure raiders who use the legislative framework and the judicial system in order to expropriate minority shareholders in several banks (figure 6).

Figure 6: Raider Attack Cycle



First, these obscure raiders rely on a network of informants that allow them to identify who the owners of the shares are (staff from the share registries or staff from the financial institution in charge of keeping the shareholders registry). After the identification of the owners of the shares, the obscure raiders use different schemes to falsify information alleging that the owner of the said shares owes them money. It is common practice for the obscure raiders to hide behind the corporate veil of a shell company.

Second, the obscure raiders identify remote provincial courts willing to enforce the falsified claim. According to information provided by multiple stakeholders, the corruption levels of provincial courts is quite high, and in order for the obscure raider to obtain a debt enforcement decision, he has to bribe the judge in advance. Then, the judge issues a court decision within 24/48 hours and the opposing party is not notified that is being sued. The decision of the court is then transmitted to a bailiff that will be in charge of executing the court's decision.

Third, the bailiffs, who also act in concert with the obscure raiders and the courts, identify the assets that can be seized in order to enforce the debt. In this case, the bailiffs always choose to enforce payment by seizing the shares owed by the debtor, rather than checking the debtor's banks accounts, which would be the normal practice in case of debt enforcement procedures. The bailiff visits the share registries and requests the registrar to change the ownership of the shares as suggested by the court's decision. Once again, neither the bailiff nor the registrar notifies the debtor.

Fourth, the obscure raider obtains sufficient shares required for him to take control of the bank through raider attacks. As soon as he takes control of the bank, he replaces the CEO and the supervisory board during the annual or extraordinary shareholders meeting. Then the board and the CEO will work directly for the interest of the controlling shareholder – for instance, promoting an expansion of lending to new borrowers (likely, shell companies controlled by the UBOs) and large placements of funds with foreign banks. Similar transactions are known to occur in other financial institutions and privately owned companies, giving the raider control over multiple financial institutions and companies, thus creating systemic risks, and information on selected company targets may be obtained through dishonest means.

Institutional environment around the scheme

i) Judicial system

These raider attacks are taking place because of the absence of rule of law. Market participants, government officials and stakeholders have raised concerns about the levels of corruption in the judiciary. Particularly, in small provinces, the lack of resources, the limited qualifications of the judges, and the low level of wages of court officials create the perfect environment for corruption opportunities. The judges who are acting in concert with obscure raiders issue court decisions without following the due process procedures required by the law (e.g. notification of parties or appeal and procedural timeframes). According to the World Bank's Doing Business database, the procedure to obtain a court judgment in Moldova can take up to 190 days.[14] In the case of the raider attacks, however, it just takes a few days, which shows that the judge is responding to different interests, and is acting in concert with obscure raiders.

As the decision is issued by the judge, bailiffs and share registries cannot question its validity because it is an official court document. Furthermore, in some cases the shares registry is known to be owned by similar UBOs; and there are rumors that past ownership records are in some cases destroyed (and there are inadequate or inexistent back-ups).

ii) Bailiffs

Some bailiffs are also working in concert with obscure raiders. As soon as the bailiff is handed the illegal court decision, he will immediately start the enforcement procedures. As with the courts, the bailiff does not follow the due process procedures existing in the Civil Procedure and Enforcement codes.[15] Again, the party that is victim of the attack is not notified that a debt enforcement procedure has been issued against him/her. Moreover, due to the fact that the party is not informed, it cannot appeal the enforcement procedure. Another interesting issue is that in legitimate operations, it is global practice for bailiffs to seize liquid assets first such as bank accounts, real estate, vehicles or valuable movables instead of shares. However, in the case of raider attacks, the bailiffs go straight to the share registry to conduct the enforcement procedure by changing the ownership of the shares. Another issue is the efficiency of the enforcement procedure. According to the World Bank's Doing Business database, the procedure to enforce a

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[14] For more information please visit: http://www.doingbusiness.org/data/exploreeconomies/moldova#enforcing-contracts

[15] According to Article 178 of the Civil Procedure Code and Article 160 of the Enforcement Code, a copy of the decision should be issued to the defendant. Moreover, the debtor should be informed by the bailiff regarding the voluntary execution within 15 days.

contract in Moldova can take up to 105 days in Moldova.[16] In these raider cases, it just takes a few days.

iii) Share registries

In Moldova there are eleven share registries which are privately owned JSCs. Similar to the banking sector, the ownership of these registries is not transparent. For example, according to local stakeholders, the registry in charge of keeping the shares of two of the largest banks in the system is owned by the UBO who recently acquired a controlling number of shares in the same banks through the above process. Again, the share registry does not verify the validity of the court's decision or enforcement order and executes the change of ownership procedure as requested by the bailiff. The victims of the attacks are not notified that their shares have been transmitted to another person.

iv) National Bank Moldova

The NBM has sometimes tried to take actions to block the voting of these blocks of illegally obtained shares. However, on October 1, 2013, the Constitutional Court of Moldova issued a court ruling significantly reducing the administrative powers of the NBM. As a result, any administrative act taken by the NBM can be suspended as soon as its action is appealed. The administrative act will remain suspended until a final verdict is reached by the court (except for issues related to liquidations and removal of operational licenses of banks). As a result, many actions taken by the NBM (e.g. blocking the right of vote of shareholders acting in concert without disclosing to the general shareholders meeting and/or the NBM, as in the case of Victoria Bank) can be appealed and suspended while the procedure is ongoing.

In addition, the Civil Procedure Code has provisions allowing an interested party to request an injunction from the court prohibiting an administrative authority (e.g., the NBM) from performing certain administrative activities (e.g., prohibiting the NBM to adopt a decision prior to enacting such decision).

This Constitutional Court ruling and the Civil Procedure Code reduce the NBM's powers to effectively exercise its supervision and oversight mandate.

v) National Commission of Financial Markets

All commercial banks in Moldova are required by law to register their securities at the stock exchange since they are public interest entities. However, the NCFM does not have supervisory

[16] For more information please visit: http://www.doingbusiness.org/data/exploreeconomies/moldova#enforcing-contracts

powers over commercial banks. Only the NBM can supervise commercial banks according to the law. As a result, despite the large number of obscure transactions that have taken place over the last two years, the NCFM cannot initiate any investigation about these sudden changes of ownership of banks.

Moreover, the NCFM is in charge of licensing and supervising the share registries. While the NCFM is responsible for vetting the initial owners upon licensing, it performs no fit and proper reviews upon subsequent change in ownership, nor does it rigorously vet board members and CEOs.

vi) National Securities Depository

The NSD is a privately owned JSC. The NSD has 32 shareholders including the Moldova Stock Exchange.[17] The role of the NSD is to facilitate the settlement of securities-related transactions and provide depository services.

When shares are traded at the stock exchange, they have to be deposited by brokers in nominal accounts (direct or collective accounts) provided by the NSD. However, during these transactions, ownership of the shares cannot be effectively controlled by the NSD because it is not connected electronically to the eleven share registries. Parties to a transaction only provide paper documents from the share registries proving ownership of the shares. However, these documents can be easily forged.

Recommendations

i) Short term reform recommendations

- **Change the 5 percent 'significant interest' threshold**

Currently, according to Article 15 of the LFI, the acquisition of more than 5 percent of the shares of a bank has to be reported and approved by the NBM. As well, the spirit of the law provides the authority to the NBM to link ownership that is related and to address the UBO. However, these provisions have been abused by market participants.

Currently, lowering the 5 percent threshold to 1 percent is being considered. Although this revision would increase the volume of red tape for those who choose to circumvent the law, it is not a fail-safe measure since it doesn't address the fundamental problem of ultimate change in

[17] The NSD has indicated it is considering inviting the registries to become shareholders of the NSD itself, purportedly to allow easier access to registry information, but possibly giving even more control to the UBOs of the registries.

control and beneficial ownership. While a given threshold can be used as a trigger for NBM (or NCFM in the case of insurance companies) evaluation, it should not be the only indicator for a fit and proper evaluation. As demonstrated in one recent bank case whereby the NBM suspended the voting rights of a group acting in concert, the NBM should actively use the extent of the law to address and suspend the rights of those who use unscrupulous means to gain control of the country's institutions and companies. Furthermore, law should provide the NBM the right to declare null and void ownership transactions that are deemed illegal, including those that were consummated with the intent of bypassing regulation.

- **Re-establish the supervisory authority of National Bank of Moldova**

Currently, the supervisory powers of the NBM have been dramatically curtailed by the Constitutional Court's decision of October 1, 2013. According to the Constitutional Court ruling, any administrative action taken by the NBM can be appealed and suspended until a final verdict is reached by the court.

Moldova is one of the very few countries in the world where administrative acts taken by the central bank can be suspended pending decision on the appeal. While the right to appeal any administrative or judicial decision should be preserved, it is important to provide the necessary tools to the NBM to fulfill its mandate effectively. Therefore, the power of the NBM to exercise its functions effectively should be restored immediately to avoid further potential damage to the banking system. Moreover, the Civil Procedure Code must be amended to eliminate the loopholes allowing interested parties to take advantage of the process by requesting injunctions from the court prohibiting the NBM from performing its administrative activities.

Finally, the amended regulatory framework should clearly specify the authority, scope, procedure, timeframe, and location for the review of the NBM decisions (NBM Council of Administration vs appeal courts/constitutional court).[18]

- **Require rigorous vetting of share registries' current owners, change of ownership, board members and CEOs by the NCFM**

Currently, the NCFM licenses share registries without rigorously vetting their board members and CEOs. Moreover, the NCFM does not monitor changes in ownership of these companies. Since share registries are in charge of handling very sensitive economic information, the board composition, CEO and ultimately the ownership should go through a rigorous vetting process by the regulator, NCFM. Moreover, the ownership of these companies should be transparent and accessible to all stakeholders. For this reason, it is imperative that the NCFM conducts fit and proper assessments of each board member, CEO and ultimate owner of the share registries to identify and address conflicts of interest.

[18] See joint IMF and WB joint comments on *Law on Amending and Supplementing Some Legislative Acts (the Law) adopted by the Parliament of Moldova in December 2013* and letter from the IMF legal department *Summary of Outstanding Issues in the Legal Framework for Review of Administrative Decisions.*

ii) Medium term reform recommendations

- **Consolidate the share registration and record keeping processes under the control of an independent authority**

Currently, eleven share registries are providing share registration and record keeping services to thousands of JSCs in Moldova. Share registries are privately owned JSCs. Similar to many of the Moldovan banks, ownership of share registries is not transparent. When directors are asked to disclose the identity of the owner of the registries, they always refer to a legal entity and they are unable to identify or disclose who effectively owns it. Due to the obscurity of the UBOs, it is highly plausible that these registries are also owned by (or are connected with) the same perpetrators of the raider attacks.[19] A similar situation is also plausible with the NSD which is also privately owned.

Given the prevailing weak rule of law, the registries and the NSD should not remain in the hands of the private sector. Therefore, a consolidation is recommended of all registries into a single entity overseen by an independent authority that can ensure better governance and transparency. Such a structural change would require that all oversight responsibilities be consolidated under the authority, without being shared by other entities. This is crucial to ensure that authority is made clearly responsible and held accountable for its actions. Splitting responsibilities among two or more entities would confuse and blur lines of responsibility; put the involved entities at potential risk of being charged for the other's (possible) mismanagement; and potentially allow for arbitrage or circumvention by other third parties.

iii) Long term reform recommendations

- **Reform the judicial system including the bailiff system**

An extensive review of the judicial system is imperative and, judicial standards raised including, *inter alia*: increasing the entry standards for the profession of judge; increasing the wages of judges; reviewing the existing codes of conduct to increase the liability regime of judges in case of corruption; and ensuring that the right enforcement structures are in place to secure the independence and transparency of the judicial system. A similar strategy should be followed regarding the bailiff system. Finally, this reform process must be accompanied with intensive training on financial and corporate law issues to increase the specialization of certain judges.

[19] Indeed, given the very low level of trading in shares, and diseconomies of scale in operating 11 registries in a small economy, it seems highly unlikely that legitimate business would justify continuation of multiple registries.

Annex 2: Principles for Enhancing Corporate Governance Basel Committee, October 2010

Principle 1
The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management.

Principle 2
Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank.

Principle 3
The board should define appropriate governance practices for its own work and have in place the means to ensure that such practices are followed and periodically reviewed for ongoing improvement.

Principle 4
In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

Principle 5
Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.

Principle 6
Banks should have an effective internal controls system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

Principle 7
Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should

keep pace with any changes to the bank's risk profile (including its growth), and to the external risk landscape.

Principle 8
Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

Principle 9
The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions.

Principle 10
The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended.

Principle 11
An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

Principle 12
The board and senior management should know and understand the bank's operational structure and the risks that it poses (ie "know-your-structure").

Principle 13
Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations. They should also seek to mitigate the risks identified (ie "understand-your-structure").

Principle 14
The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.